
**AUDIT OF PAYMENT RETENTION FUNDS ESTABLISHED BY THE
RESOLUTION TRUST CORPORATION FOR SECURITIZED
TRANSACTIONS SERVICED BY LOMAS MORTGAGE USA**

Audit Report No. 99-004
January 12, 1999



OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

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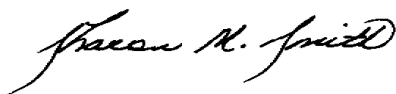
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DATE: January 12, 1999

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Division of Resolutions and Receiverships

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FROM: Sharon M. Smith
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SUBJECT: *Audit of Payment Retention Funds Established by the Resolution Trust Corporation for Securitized Transactions Serviced by Lomas Mortgage USA*
(Audit Report No. 99-004)

This report presents the results of an audit of the payment retention funds (PRF) that the Resolution Trust Corporation (RTC) established for five securitized transactions for which Lomas Mortgage USA (Lomas) was the master servicer. We selected those transactions for review based on unreconciled PRF amounts that had not been returned to the Federal Deposit Insurance Corporation (FDIC).¹

To select a master servicer for detailed review, we obtained a listing of mortgage-backed securities transactions from the FDIC's Mortgage-Backed Securities Administration (MBSA). The transactions included the original PRF balances, outstanding balances as of December 1996, and master servicers' and trustees' names. We then identified transactions that had substantial PRFs that had not been returned to the Corporation. Next, we eliminated those servicers that were either involved in litigation with the Corporation or identified by FDIC officials as participating in the Corporation's global settlement with master servicers. We then selected the Lomas for detailed review.

Specifically, Lomas was the master servicer for transactions 1992-11, 1992-15, 1992-18P, 1993-04P, and 1993-05P. The outstanding principal balances of loans for those transactions totaled about \$2.4 billion at the time the transactions closed. The RTC established PRFs totaling \$60.3 million for four of the five securitized transactions. When we selected Lomas for audit in April 1997, \$28.2 million of the \$60.3 million had not been returned to the Corporation.

¹The RTC ceased operations on December 31, 1995, and the FDIC assumed the RTC's responsibilities.

BACKGROUND

Securitization is the process of pooling similar, illiquid mortgage loans and issuing marketable, liquid securities backed by the mortgage loans. The pooled loans serve as collateral for the newly formed mortgage-backed securities. All types of mortgage loans are used as collateral including one-to-four family residential mortgages, multi-family residential mortgages, manufactured housing loans, home equity loans, and commercial loans.

Typically, each securitization transaction involved three parties whose roles and responsibilities were governed by a pooling and servicing and a master-servicing agreement. The three parties involved in each of the five transactions we selected were the RTC (seller), Lomas (master servicer), and Bankers Trust (trustee). Master servicers, generally, were responsible for (1) servicing securitized loans either directly or through subservicing and (2) maintaining documentation to adequately account for loan activity. For Lomas' transactions, loans were serviced by primary servicers who collected loan payments and forwarded them to the master servicer. The master servicer, acting as a conduit, (1) sent the funds to a trustee, who passed the funds to the purchasers of the securities (investors) and (2) maintained documentation to account for loan activity.

The RTC, generally, issued a credit-enhanced, rated debt instrument with a predictable stream of payments.² For some of the loans that the RTC securitized, it established PRFs, credit-enhancement reserve funds (CRFs), and representations and warranties funds. Table 1 shows the amount established for each of those funds for the five Lomas transactions.

Table 1: RTC-Established Funds for Lomas Securitization Transactions

Transaction Number	Payment Retention Fund	Credit Enhancement Reserve Fund	Representations and Warranties Fund
1992-11	\$28,554,065	\$ 86,400,709	\$ 53,875,817
1992-15	18,571,896	65,961,962	23,824,314
1992-18P	11,996,719	29,770,643	16,609,197
1993-04P	0	7,600,000	3,443,028
1993-05P	1,168,001	7,610,080	4,110,135
Totals	\$60,290,681	\$197,343,394	\$101,862,491

Source: OIG analysis of FDIC summary schedules for PRFs, CRFs, and representations and warranties funds.

Payment Retention Fund

The purpose of a PRF was to provide the master servicer with funds to make up shortfalls in expected monthly distributions of borrowers' loan payments from primary servicers. Generally, the RTC set up PRFs based on 3 months of principal and interest payments for each securitized

²Securitized transactions with scheduled principal and interest payments resulted in a predictable stream of payments. Transactions with actual principal or interest payments were not predictable and the stream of payments depended on actual amounts paid by borrowers.

loan and usually established the funds in the names of both the RTC and the master servicer.³ However, the principal and interest generated from any permitted investments belonged to the RTC. In addition, at the end of the 3-month period, the master servicers were to return the PRFs plus any earned interest to the Corporation in full.

The RTC established PRFs totaling \$60.3 million for four of the five Lomas transactions. The RTC did not establish a PRF for transaction 1993-04P because it was an actual transaction, which entitled investors to only the loan payments actually remitted by borrowers rather than a specified stream of payments.

The RTC generally executed pooling and servicing, ancillary, or other similar agreements that provided the purpose and criteria for the use of each PRF. To make draws from a PRF, the master servicer was required to submit officer certifications to the trustee specifying the amounts to be withdrawn. For the Lomas transactions, when the master servicer identified shortfalls from borrowers, the trustee drew funds from the PRF to cover the shortfalls and remitted the funds to the investors. When borrowers made up shortfalls in subsequent payments, the master servicer should have reimbursed the PRF.

Credit-Enhancement Reserve Fund

The purpose of a CRF was to provide funds to cover distribution shortfalls resulting from realized losses or delinquencies. A loss could occur, for example, when a delinquent borrower's loan is foreclosed and the underlying collateral is sold for less than the unpaid loan balance. The RTC established CRFs totaling \$197.3 million for the five Lomas transactions. Like the PRFs for the Lomas transactions, the CRFs were held in the names of the RTC and the trustee and were controlled by the trustee.

Representations and Warranties Fund

The purpose of a representations and warranties fund was to pay claims arising from breaches in the representations and warranties made by the RTC regarding the secured products included in the transaction. For example, claims could be filed when the RTC included loans that it did not own in the securitization transactions. Any claim against a representations and warranties fund should have been applied to the specific institution that owned the loan for which the claim was filed. The RTC contracted with MGIC Investor Services Corporation (MISC)⁴ to process claims filed for breach of representations and warranties related to single-family and manufactured housing transactions. On the other hand, the RTC processed claims filed for commercial and multi-family transactions. The RTC set aside a portion of the sales proceeds for each securitized

³The RTC generally established each PRF in the master servicer's and the RTC's names with the master servicer maintaining control over the account. However, the PRFs for the Lomas transactions were established in the trustee's and RTC's names with the trustee maintaining control.

⁴Although the RTC referred to MGIC as its contractor for claims processing, the Corporation's contract is actually with MISC, a subsidiary of MGIC.

transaction to pay claims for breaches of representations and warranties. The RTC established representations and warranties funds totaling \$101.8 million for the five Lomas transactions.

Important Events Related to the Lomas Transactions and FDIC Operations

The Lomas transactions experienced a change in master servicers when Lomas filed for bankruptcy and sold the servicing for the five RTC transactions to First Nationwide Mortgage Corporation (FNMC). Management also changed when the FDIC assumed control of the transactions at the RTC's sunset. Accordingly, it is important to understand certain events that occurred during the life of the Lomas transactions. Specifically,

- On October 10, 1995, Lomas filed for chapter 11 reorganization with the federal bankruptcy court in Delaware. Although Lomas' bankruptcy documents did not list the payment retention funds, they did list the securitized transactions. The documents showed the RTC, the FDIC, and Bankers Trust as creditors in the *Executory Contracts and Unexpired Leases* section of the chapter 11 bankruptcy documents.
- The bankruptcy court provided notification of Lomas' bankruptcy to the RTC, the FDIC, and Bankers Trust and established April 4, 1996, as the deadline to file proofs of claim.
- Lomas Financial Corporation, with approval from the bankruptcy court, sold Lomas' loan servicing portfolio, including its securitized and unsecuritized loans, to FNMC in two installments on October 2, 1995, and January 31, 1996.
- The RTC, based on congressional mandate, ceased operations on December 31, 1995, and its responsibilities were transferred to the FDIC. However, some of the RTC officials responsible for the oversight and management of securitized transactions retained those responsibilities with the FDIC.
- On January 1, 1996, the FDIC's National Sales Support Office (NSSO) and its accounting contractor, Thompson Cobb, Bazilio & Associates (TCBA), began transitioning its responsibilities for reconciling and settling the transactions to the FDIC's Division of Finance (DOF).
- Based on an Office of Inspector General audit,⁵ the FDIC forwarded a letter in February 1996 to all trustees and master servicers requesting that outstanding PRFs be returned to the Corporation. However, the FDIC did not receive any of the PRFs for the Lomas transactions until it closed the bank accounts for those funds in May 1996.
- As of December 31, 1997, 100 of the RTC's 124 securitized transactions had been reconciled and settled. The remaining 24 transactions, including the Lomas transactions, had significant problems.

⁵Report entitled *Audit of RTC's Payment Retention Funds* (audit report number 96-132, dated November 7, 1996).

- The FDIC requested and, during June 1997 and September 1997, respectively, received two wires totaling about \$10.1 million from NationsBanc. Those funds appeared to be related to the Lomas transactions.⁶

OBJECTIVE, SCOPE, AND METHODOLOGY

The audit objective was to determine whether the master servicer properly accounted for the PRFs that the RTC established for the Lomas transactions. During the audit, we expanded the scope to review the FDIC's oversight of the master servicer and efforts to reconcile and settle the outstanding PRFs.

To accomplish the objectives, we interviewed officials from the FDIC's Division of Resolutions and Receiverships (DRR), MBSA and Asset Claims Administration; DOF; and Legal Division. We also reviewed NSSO's policies and procedures related to PRFs as well as RTC and FDIC reconciliation schedules, transaction and correspondence files, bank statements, transaction statements, pooling and servicing agreements, and master-servicing agreements related to the Lomas transactions. In addition, we reviewed the prospectus for transactions 1992-11 and 1992-15; private placement memoranda for 1992-18P, 1993-04P, and 1993-05P; and an ancillary agreement for transaction 1992-11.

At FNMC's Master Servicing Division in Dallas, Texas, we reviewed data that Lomas and FNMC maintained related to the PRFs. Specifically, we reviewed transaction files, activity schedules, and correspondence related to the securitized transactions and FNMC's contacts with the FDIC regarding reconciling and settling the transactions.

In addition, we interviewed FDIC Legal Division officials to obtain information on the PRFs and Lomas' chapter 11 bankruptcy, FNMC's asset purchase agreement with Lomas, and proofs of claim filed in relation to Lomas' bankruptcy. We also interviewed Asset Claims Administration officials to obtain information on the FDIC's process for reviewing and settling claims and the total number and dollar value of claims relating to the five Lomas transactions that had been filed and paid. We reviewed documents related to Lomas bankruptcy, such as the chapter 11 reorganization plan, U.S. Bankruptcy Court docket, creditor listing, and asset-sale agreement with FNMC.

To determine the adequacy of the FDIC's oversight of the master servicer, we requested all documents related to the FDIC's on-going discussions with FNMC regarding reconciling and settling the transactions. In addition, during the entrance conference held on May 21, 1997, and in subsequent meetings, FDIC officials requested that the OIG delay its visit to FNMC because they believed that our visit could jeopardize the FDIC's on-going discussions with FNMC. Accordingly, we delayed our visit to FNMC until October 7, 1997.

⁶NationsBanc assumed primary servicer responsibilities when it purchased Boatmen's National Mortgage, which had previously purchased National Mortgage Corporation, one of the initial primary servicers for the Lomas transactions.

In August 1998, we met with FDIC officials to obtain their oral comments on the OIG's discussion draft report issued on August 12, 1998. During subsequent meetings held in August and September 1998, the FDIC officials provided additional documentation that had been previously requested but not provided to the auditors. Based on our review of that additional data and conversations with FDIC officials, we revised the discussion draft report, as appropriate.

Because Lomas filed bankruptcy on October 10, 1995, we could not discuss the audit with Lomas principals, such as its president, vice president, or chief executive officer. Accordingly, the OIG views the Lomas bankruptcy as an external impairment affecting the scope of the audit.

The OIG did not evaluate FNMC's system of internal controls related to the securitized transactions because we concluded that the audit objective could be met more efficiently by conducting substantive tests rather than placing reliance on the internal control system. The OIG conducted the audit from April 1997 through September 1998 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

Of the \$60.3 million in PRFs that the RTC established for four of the five Lomas transactions, approximately \$28.2 million had not been properly accounted for or returned to the FDIC. The FDIC's and FNMC's failure to reconcile and settle the Lomas transactions and recover outstanding PRFs can be attributed, in part, to the RTC's origination and oversight of the transactions. Specifically, the RTC's structuring of the loan servicing and types of loans included in the Lomas transactions created managerial problems for Lomas and the FDIC. In addition, the RTC did not always provide adequate guidance for the use, investment, and return of the PRFs it established. Further, although it was alerted to problems relating to the Lomas transactions during 1993 and 1994, the RTC did not take timely corrective actions to address those problems. Also, the RTC's original structuring of the loans included in the transactions breached the representations and warranties that it made, resulting in claims of over \$117 million.

In addition to the problems relating to the RTC's origination and oversight, Lomas⁷ did not adequately account for the PRFs established for the transactions. Specifically, documentation related to Lomas' draws from and reimbursements to the PRFs was not adequate to determine why specific draws were made or how reimbursements were calculated. In addition, Lomas' records did not provide any evidence of follow-up with primary servicers whose monthly remittances were lower than the expected scheduled payments.

To further compound the problems, after assuming the RTC's responsibilities in January 1996, the FDIC did not adequately oversee the Lomas transactions. Specifically, the FDIC did not protect its interest by filing a proof of claim with the bankruptcy court for the outstanding payment retention funds when Lomas filed for bankruptcy. In addition, the FDIC had not reviewed documents related to Lomas' bankruptcy or the sale of its loan-servicing portfolio to FNMC to

⁷Although FNMC is the current master servicer, the majority of the PRF draws were made during the period when Lomas performed as the master servicer. Accordingly, the adequacy of Lomas' records is pertinent to the successful reconciliation of the transactions.

determine FNMC's legal liability for returning the outstanding PRFs. In addition, the FDIC had not analyzed the \$10.1 million received from NationsBanc, one of the primary servicers for the Lomas transactions, to determine the proper application of the funds. Finally, initial communications between the FDIC and FNMC officials were not effective in resolving significant reconciliation issues in a timely manner. However, communications and efforts to resolve outstanding issues and reconcile the transactions improved during June 1998.

Although the RTC received about \$2.1 billion, net of expenses, when investors purchased the five Lomas transactions, draws made on the PRFs and CRFs and claims paid for breaches of representations and warranties reduced that amount by approximately \$125.1 million. Based on our audit, the OIG recommends that the Director, DRR, and the Acting Director, DOF, take specific actions to expedite reconciliation and settlement of the transactions.

PAYMENT RETENTION FUNDS WERE NOT RETURNED TO THE FDIC

The FDIC had not received \$28.2 million of the \$60.3 million that the RTC included in the four PRFs for the Lomas transactions. Specifically, the RTC established the four PRFs in September 1992, October 1992, December 1992, and February 1993—generally, for 90-day periods. The pooling and servicing and ancillary agreements for two of the four PRFs required the funds to be returned in full between December 1992 and May 1993. However, the RTC did not request that Lomas return the PRFs in a timely manner. A portion of the funds were not obtained until May 1996—over 3 years after the funds were established—when the FDIC received approximately \$32.1 million, which left about \$28.2 million outstanding. As of June 1998, the \$28.2 million had been outstanding for over 5½ years. Table 2 shows the original balance, interest earned, amount returned to the FDIC, and the June 1998 outstanding balance for the PRFs.

Table 2: PRFs Established for Lomas Securitization Transactions

Transaction Number	Original PRF Balance	Interest Earned As of May 1996	Returned to the FDIC in May 1996	Outstanding Balance As of September 1998
1992-11	\$28,554,065	\$1,969,011	\$22,417,848	\$ 8,105,228
1992-15	18,571,896	607,481	9,827,490	9,351,887
1992-18P	11,996,719	226,845	1,588,316	10,635,248
1993-05P	1,168,001	112,536	1,202,073	78,464
Totals	\$60,290,681	\$2,915,873	\$35,035,727	\$28,170,827

Source: OIG analysis of PRF bank statements and NSSO analysis of PRFs due.

During May 1996 when the FDIC and Bankers Trust closed the Lomas PRF bank accounts, the Corporation recovered \$35,035,727 consisting of \$32,119,854 in principal and \$2,915,873 in earned interest. The FDIC notified FNMC that the PRF accounts had been closed and that the funds would not be available for the May 25, 1996, distribution. As of September 1998, \$28,170,827 of the PRFs had still not been returned to the FDIC. Moreover, the accounts had

not been reconciled to determine whether draws and reimbursements were appropriate and accurate. In addition, the FDIC had not determined the extent of FNMC's legal liability for the PRFs.

THE RTC'S ORIGINATION AND OVERSIGHT OF THE LOMAS TRANSACTIONS CREATED MANAGEMENT AND RECONCILIATION PROBLEMS

The FDIC's failure to complete the reconciliation process for the Lomas transactions and recover outstanding PRFs can be attributed, in part, to the RTC's origination and oversight of the transactions. Specifically, the RTC structured the five Lomas transactions differently from its other securitization transactions. The Lomas transactions consisted of loans serviced by others (LSBO) and required primary servicers to continue servicing the loans and remit monthly loan payments to Lomas. Further, the types of loans that the RTC included in the Lomas transactions presented a multitude of managerial problems for the master servicer and the RTC. Specifically, the RTC made numerous errors in the types of loans it included in the five transactions, which breached the representations and warranties it provided to the master servicer.⁸ In addition to making numerous errors when it originated the Lomas transactions, the RTC did not provide adequate criteria for the use and return of the PRFs established for those transactions.

Moreover, the RTC's oversight of the transactions and its failure to take timely corrective actions compounded the origination problems. Specifically, during 1993 and 1994, the RTC was alerted to significant accounting and reporting issues and oversight concerns related to the Lomas transactions. In June 1994, the RTC's OIG issued a report resulting from an audit of Lomas' servicing of unsecuritized RTC loans. Lomas was servicing other RTC loans along with the loans securitized in the five Lomas transactions. The audit report entitled *RTC's Oversight of Lomas Mortgage USA, Inc.* (A94-KC-010, dated June 6, 1994) identified several problems relating to Lomas' handling of funds from both unsecuritized and securitized loans. However, the RTC did not take timely actions to correct the identified problems.

The RTC's origination problems and inadequate oversight significantly impacted the FDIC's ability to reconcile and settle the transactions. Specifically, as of June 1998, over 4,600 claims totaling about \$117.1 million had been filed as a result of breaches in the representations and warranties that the RTC provided under the Lomas transactions. The \$117.1 million in claims filed as of June 1998 exceeded the amount initially set aside to pay claims by \$15.2 million. As of June 1998, the RTC and FDIC had paid about \$77.7 million of those claims and not reviewed about \$6.4 million. The remaining \$33 million in claims had been denied or were pending final decision. All claims related to the Lomas transactions will have to be reviewed to determine their effect on the PRF and transaction reconciliations.

Appendix I contains a detailed discussion of the RTC's origination and oversight of the Lomas transactions and the associated problems that have affected the FDIC's ability to reconcile the transactions and recover outstanding PRFs.

⁸The RTC originated its securitized transactions with advice from a financial advisor after a contractor completed due diligence of the loans to be securitized. For the five Lomas transactions, there were two financial advisors and five due diligence contractors.

LOMAS DID NOT PROPERLY ACCOUNT FOR THE PAYMENT RETENTION FUNDS

In addition to the initial problems relating to the RTC's planning and origination of the LSBO transactions, Lomas did not properly account for the PRFs established for those transactions. Specifically, documentation related to Lomas' draws from and reimbursements to the PRFs was not adequate to determine why Lomas made specific draws and how Lomas calculated reimbursements to the accounts. In addition, Lomas' records did not provide any evidence of follow-up with primary servicers whose monthly remittances were smaller than the expected scheduled loan payments.

Inadequate Records

During the initial 3 months of the transactions, Lomas made significant draws on the PRFs. For example, for transaction 1992-11, draws for the first 3 months totaled \$16 million, or about 56 percent of the total original PRF balance. Likewise, for transaction 1992-15, draws for the first 3 months totaled \$18.6 million. However, Lomas' documentation was not adequate to support those draws. The amount of PRF draws shown on Lomas' source documents often did not agree with actual draws. In addition, shortfalls from primary servicers shown on comparison reports that Lomas prepared usually differed from amounts shown on officer certifications and bank statements. Thus, we could not reconcile Lomas' PRF draws to source documentation.

Table 3 shows the remittance shortfalls and subsequent PRF draws that Lomas made based on applicable bank statements and officer certifications during the first 3 months of transactions 1992-11 and 1992-15.

Table 3: Remittance Shortfalls and Payment Retention Fund Draws

Transaction Number	Month and Year	Remittance Shortfalls	PRF Draws	PRF Draws per Bank Statement
1992-11	10/92	\$ 1,774,474	\$2,505,180	\$ 2,505,180
1992-11	11/92	11,082,926	6,268,393	6,268,393
1992-11	12/92	5,736,912	7,108,617	7,232,317
1992-15	11/92	3,503,156	9,874,971	10,357,950
1992-15	12/92	6,224,498	6,826,548 ^a	5,066,523
1992-15	01/93	4,107,849 ^b	4,422,667	3,197,805

^aThe December 1992 transaction file for 1992-15 contained inconsistent reconciliations showing different amounts drawn from the PRF. The second reconciliation showed \$4,979,094 drawn from the PRF.

^bRemittance overage per comparison report.

Source: OIG analysis of PRF bank statements and Lomas transaction files, reconciliation schedules, and comparison reports.

We also could not determine from the comparison reports what would have been the correct amount of draws from or reimbursements to the PRFs. Lomas did not maintain the comparison reports on a cyclical basis and did not identify shortfalls or overages for a specified reporting period, making reconciliation virtually impossible. Furthermore, the shortfalls and overages that Lomas identified on the comparison reports generally did not agree with the shortfalls or overages reported on its reconciliation schedules that were generated on a monthly cyclical period. Further, Lomas' reconciliation schedules did not tie advances or end-of-month remittances to previously reported shortfalls or overages. Because we could not find adequate support for the draws, we could not reconcile reimbursements made to the PRFs.

Although officer certifications were generally available for the draws and reimbursements for transactions 1992-11, 1992-15, and 1992-18P, Lomas' transaction files did not contain officer certifications to support PRF draws for transaction 1993-05P. FNMC officials stated that they were not aware that transaction 1993-05P had a PRF and they could not provide any information on the missing officer certifications. Further, FNMC officials said that they had not performed any analyses on 1993-05P and did not plan to analyze that transaction.

Lack of Follow-up

Lomas' comparison reports did show that primary servicers' remittances, specifically those remitted by NationsBanc's predecessors, were significantly less than scheduled loan payments, and Lomas made significant draws from the PRFs to cover those shortfalls. However, there was no evidence indicating that Lomas followed up with primary servicers to determine (1) why remittances were less than scheduled and (2) whether identified shortfalls were included in subsequent remittances. Table 4 shows, for selected months, the shortfalls in the monthly loan payments when compared to the scheduled payments remitted by NationsBanc's predecessor primary servicers.

Table 4: Primary Servicer Remittance Shortfalls for Selected Months

Month/Year	Transaction	Shortfall
December 1992	1992-11	\$2,696,508
October 1993	1992-11	802,524
June 1994	1992-11	1,593,343
December 1992	1992-15	4,158,131
December 1993	1992-15	2,398,496
February 1993	1992-18P	4,895,442
May 1993	1992-18P	4,115,983
September 1993	1992-18P	2,845,613

Source: OIG review of Lomas transaction files and comparison reports.

THE FDIC DID NOT ADEQUATELY OVERSEE LOMAS TRANSACTIONS

Since it assumed the RTC's responsibilities in January 1996, the FDIC had not adequately overseen the five Lomas transactions and \$28.2 million in PRFs remained outstanding as of September 1998. Specifically, the FDIC did not protect its interest by filing a proof of claim with the bankruptcy court for the payment retention funds. In addition, the FDIC had not reviewed documents pertinent to Lomas' bankruptcy and the subsequent sale of its loan-servicing portfolio to FNMC to determine FNMC's legal liability for reconciling and settling the transactions and returning the PRFs to the Corporation. The FDIC had also not determined whether the \$10.1 million received from NationsBanc, one of the primary servicers for the transactions, related to the Lomas transactions. Finally, initial communications between FDIC and FNMC officials regarding reconciliation and settlement issues were ineffective. However, communications and efforts to resolve outstanding issues improved during the period covered by our audit.

Failure to File Proof of Claim

The FDIC did not file a proof of claim with the bankruptcy court to protect the Corporation's interest in the outstanding PRFs. Although Legal Division and NSSO officials, after receiving notification of Lomas' filing, discussed Lomas' bankruptcy and the possibility of filing a proof of claim for the PRFs, the FDIC did not file a proof of claim. Because the FDIC did not file a proof of claim with the bankruptcy court before the April 1996 deadline, the Corporation forfeited its rights to recover any funds through Lomas' bankruptcy proceedings.

Applicable agreements stated that PRFs plus any earned interest were to be returned to the RTC in full at the end of the 90-day period for which they were established. At the time that Lomas filed bankruptcy, none of the \$60.3 million in PRFs had been returned to the RTC. On October 10, 1995, 8 days after agreeing to sell its loan portfolio to FNMC, Lomas filed for bankruptcy under chapter 11 in the United States Bankruptcy Court for the District of Delaware. Lomas listed the RTC, the FDIC, and Bankers Trust as creditors in the *Executory Contracts and Unexpired Leases* section of the chapter 11 bankruptcy documents.

Bankruptcy law requires notified creditors to file proofs of claim for unsatisfied debts by the bar date established by the bankruptcy court. Specifically, the bankruptcy notification stated:

“All persons, creditors, individuals, partnerships, corporations, associations, governmental units or other entities that wish to assert a claim . . . must file proof of such claim . . . on or before the Bar Date . . .”

The court established April 4, 1996, as the bar date for creditors to file proofs of claim under the Lomas bankruptcy proceedings.

There was considerable dialogue between FDIC’s Legal Division, MBSA, and NSSO officials regarding whether the FDIC should file a proof of claim to protect its interests. However, the FDIC did not file a claim for the \$60.3 million in PRFs that were outstanding when Lomas filed bankruptcy. Specifically, the FDIC’s Legal Division disseminated information throughout the Corporation regarding Lomas’ bankruptcy. Although Legal Division officials stated that they did not have the necessary information to file a proof of claim, they offered assistance to MBSA and NSSO officials to file necessary claims. A Legal Division official stated that the FDIC should have filed a protective claim by the bar date. The official added that the FDIC could have determined the exact amount due the Corporation after the claim was filed. In addition, NSSO officials acknowledged that the reconciliation for the transactions had not been completed and that a protective claim should have been filed to protect the Corporation’s interests. However, neither MBSA nor NSSO officials acted to file a proof of claim for the outstanding PRFs. Section 6.02 of the master-servicing agreement for transaction 1993-05P stated that the seller was responsible for filing a proof of claim should the master servicer default. The FDIC’s Atlanta, Dallas, and Irvine offices filed 20 proofs of claim in the Lomas bankruptcy proceedings for issues unrelated to the securitized transactions. However, neither MBSA nor the Legal Division officials could explain why the Corporation did not file a claim for the PRFs.

In addition, Bankers Trust, who acted in a fiduciary capacity for the investors, did not file a claim although it had the right to file. Article VII of the pooling and servicing agreement for transaction 1992-11 provided guidance and outlined the trustee’s rights in the event of default by the master servicer. Specifically, sections 7.01(d) and 7.02 of article VII stated:

“ . . . the consent by the Master Servicer to the appointment of a conservator or receiver or liquidator or liquidating committee in any insolvency, readjustment of debt, marshalling of assets and liabilities, voluntary liquidation or similar proceedings of or relating to the Master Servicer or of or relating to all or substantially all of its property shall constitute default by the master servicer.”

“ . . . the Trustee . . . shall have the right, in its own name as trustee of an express trust, to take all actions now or hereafter existing at law, in equity or by statute to enforce its rights and remedies and to protect the interests and enforce the rights and remedies of the Certificateholders (including the institution and prosecution of all judicial, administrative and other proceedings and the filing of proofs of claim and debt in connection therewith).”

Although the pooling and servicing agreement gave the legal right to the trustee, the agreement

did not make the trustee responsible for filing a claim. Accordingly, the FDIC's failure to file a proof of claim for the outstanding PRFs prior to the court-established bar date prevented the bankruptcy court from considering FDIC claims against Lomas—Lomas' successor organization.

Failure to Determine Responsibility for Reconciling and Settling PRFs

As of September 1998, over 2½ years after assuming the RTC's workload and almost 3 years after Lomas filed bankruptcy, the FDIC had not established FNMC's legal liability for the reconciliation and return of the outstanding \$28.2 million in PRFs. On April 4, 1998, MBSA submitted a formal request to the Legal Division requesting that it review Lomas' bankruptcy documents and the purchase agreement between Lomas and FNMC to determine FNMC's liability regarding the PRFs. However, as of September 29, 1998—over 5 months after MBSA requested it—the Legal Division had not provided the requested opinion.

When we requested the Lomas bankruptcy documents and the purchase agreement between Lomas and FNMC in May 1997, MBSA and DOF officials stated that they did not have copies of the documents. We obtained a copy of the bankruptcy documents from the FDIC's Legal Division. On October 1, 1997, almost 2 years after Lomas filed for bankruptcy and sold its loan servicing activities to FNMC, an MBSA official obtained and provided us with a copy of the purchase agreement.

In a May 14, 1997, letter to FNMC, MBSA outlined its position on FNMC's responsibility. Although the FDIC had not obtained a formal legal opinion based on a review of the bankruptcy documents and the purchase agreement, it stated that both industry practice and contractual obligation supported FNMC's responsibility to reconcile and settle the PRFs. Because FNMC purchased Lomas' loan servicing portfolio and was not a party to the original pooling and servicing and master-servicing agreements, it was incumbent on the FDIC to review the related documents to ensure that its position was supported.

FNMC's Executive Vice President believed that FNMC was not responsible for the reconciliation of the transactions and return of outstanding PRFs. Specifically, he stated in a June 10, 1998, letter to the FDIC that: “. . . FNMC believes that it has no contractual liability with respect to servicing transactions that occurred while Lomas was the master servicer.” In addition, FNMC's legal representatives stated that they did not believe that FNMC was liable for the PRFs and that Lomas' loans had been purchased free and clear except for servicing obligations. However, FNMC's executive vice president agreed to provide reasonable assistance in resolving issues related to the PRFs, emphasized agreed-upon procedures to initiate a limited reconciliation of transaction 1992-15, and outlined unresolved issues to be addressed by FDIC officials.

Failure to Determine Proper Application of Funds

An MBSA official requested that NationsBanc forward over \$10.1 million to the FDIC, based on a statement by an employee of the former primary servicer that was purchased by NationsBanc.

Prior to this notification, neither the FDIC nor FNMC were aware that the \$10.1 million existed or that it may relate to the Lomas transactions and, therefore, significantly affect their reconciliation efforts. NationsBanc forwarded approximately \$10.1 million to the FDIC during June and September 1997.

NationsBanc contended that the \$10.1 million related to the Lomas transactions, although it had not performed an adequate document review to support its contention. Specifically, a NationsBanc senior vice president stated that neither NationsBanc nor Boatmen's National—the former servicer, which NationsBanc purchased—had been able to document exactly what the \$10.1 million represented. In addition, neither the FDIC nor FNMC had determined how the funds related to the Lomas transactions or why NationsBanc or its predecessor did not forward the funds to the FDIC or FNMC before the Funds were requested by MBSA.

Two potential applications of the \$10.1 million could be to cover either primary servicers' monthly remittance shortfalls or representations and warranties claims related to the Lomas transactions. First, Lomas' records indicated that NationsBanc's predecessors reported substantial shortfalls for several months compared to the expected stream of funds for the mortgages being serviced. However, Lomas did not follow up to determine why the shortfalls occurred or whether they were subsequently remitted. Accordingly, the \$10.1 million could represent payment of shortfalls from prior remittances. Second, because NationsBanc and its predecessor filed claims related to the Lomas transactions, the funds could also represent payments of those claims by either MISC or the FDIC.

Determination of the proper application of the \$10.1 million, which the FDIC recorded in a suspense account, may be difficult or impossible, however. As of June 1998, MBSA and DOF officials planned to hire a contractor to review the NationsBanc records. However, on September 10, 1998, MBSA officials stated that further contact with NationsBanc indicated that the primary servicer was unable to locate any documentation related to the \$10.1 million. Consequently, the lack of documentation may hinder determining the proper application of the funds and an accurate reconciliation of the transactions.

Communication With the Master Servicer Improved

Although initial communications between the FDIC and FNMC were ineffective in resolving reconciliation issues, the FDIC's and FNMC's efforts to reconcile and settle the transactions improved after June 1998. More importantly, after initially rejecting the responsibility for reconciling and returning any outstanding PRFs, FNMC agreed to perform a limited reconciliation of one of the transactions. After FNMC purchased Lomas' loan-servicing portfolio, the FDIC provided it with detailed reconciliation schedules during November 1996. However, significant progress to complete the reconciliation and settlement of the Lomas transactions did not begin until June 1998. Before that time, unresolved issues between the FDIC and FNMC affected the reconciliation process. Moreover, before June 1998, FDIC officials had not visited FNMC to discuss reconciliation and settlement of the transactions and return of the PRFs.

In May 1997 during our entrance conference, FDIC officials stated that they were in serious discussions with FNMC to resolve reconciliation problems, including accounting for and returning outstanding PRFs. Correspondence files indicated that when the FDIC initially requested FNMC to reconcile and settle the transactions during 1996, FNMC rejected any responsibility for doing so. Specifically, FNMC officials stated that FNMC did not have the resources, staff, or time to reconcile the transactions and did not want to be responsible for PRF draws by Lomas. In addition, FNMC officials cited other operational issues, such as FNMC's automated system conversion, as reasons for not reconciling the transactions.

In addition to FNMC's reluctance to reconcile the transactions, discussions with both FDIC and FNMC officials indicated that communications between them were not always effective in resolving outstanding issues. FNMC officials believed that their requests to the FDIC for guidance, information, and clarification were not effectively resolved. For instance, FNMC's first vice president, Master Servicing Division, requested information regarding the reconciliation of the beginning balances of loans included in the Lomas transactions. Although FNMC officials believed that the RTC performed a reconciliation of the beginning balances, FDIC officials stated that no such reconciliation was performed. However, an April 17, 1996, correspondence provided by an MBSA administration specialist indicated that a reconciliation of loan level balances was performed and would be provided to FNMC. In addition, FNMC's first vice president requested information and explanations regarding the reconciliation schedules that the FDIC provided. An FNMC official believed that data provided on FDIC's reconciliation schedules were revised without adequate explanations.

Further, both FNMC and FDIC officials stated that they were not aware that the RTC established a PRF for transaction 1993-05P because they believed it was an actual transaction, which did not require a PRF. The FDIC's reconciliation schedules, bank statements, and investment reports showed that the RTC established a PRF totaling \$1.2 million for transaction 1993-05P. However, neither the FDIC nor FNMC could explain why the PRF was established or why draws had been made on it.

On March 17, 1998, FNMC's first vice president requested the FDIC to provide documentation on loan payment shortfalls, PRF activity, reconciliation of beginning loan balances, and trustee responsibilities for delinquency advances and principal and interest spreads for transaction 1993-05P. He also requested information on the \$10.1 million that the FDIC received from NationsBanc. The request indicated that FNMC requested similar information and assistance from the FDIC as far back as the fall of 1996. However, as of April 1, 1998, when the OIG held its exit briefing, FNMC officials stated that its requests were not been adequately addressed and, therefore, the issues surrounding the reconciliation were not resolved.

In an effort to facilitate the reconciliation process and properly account for the outstanding PRFs, in June 1998, FNMC agreed to perform a reconciliation project for transaction 1992-15 for the period November 1992 through May 1996. Specifically, the pilot project would attempt to (1) identify errors in Lomas' records, (2) develop a report of primary servicer shortfalls in monthly remittances, and (3) analyze cash flows into and out of the PRF and CRF for transaction 1992-15. On June 17, 1998, FNMC's first vice president stated that the project:

“ . . . will not necessarily result in a complete resolution of all of the outstanding items This work plan does not contemplate any work to ‘clear’ these items since there is no way to estimate the scope of that project at this time. There are simply too many unknowns related to the period in which Lomas was the servicer.”

Further, FNMC expressed its reservations regarding the reliability of Lomas’ data. Specifically, the first vice president stated:

“ . . . the result will only be as good as the quality of the data on which it is based. As the information predates the period where FNMC has been the servicer, we cannot assure the validity of the data. Therefore, it is possible that, following completion of these steps, the source of the unrecovered funds will still be in doubt.”

FNMC estimated completion of the reconciliation within 4 to 5 months at a cost of approximately \$150,000, which MBSA officials agreed to share equally.

MBSA officials agreed with FNMC’s approach to the pilot project and offered additional suggestions to monitor FNMC’s progress and evaluate the feasibility of applying the project to the remaining transactions. In addition, MBSA officials believed that FNMC’s agreement to perform the limited review of 1992-15 constituted a major accomplishment towards completing the reconciliation of the Lomas transactions, given FNMC’s initial reluctance to begin the process.

CURRENT STATUS OF LOMAS TRANSACTIONS

The RTC received about \$2.1 billion, net of expenses, when the five Lomas securitization transactions were sold to investors. However, because of origination errors and ineffective management and oversight by the RTC, extensive draws were made on the PRFs and CRFs and numerous representations and warranties claims were paid at a total cost of approximately \$125.1 million. Table 5 shows the net sales proceeds received by the RTC, outstanding PRFs, draws on the CRFs, and claims paid for breaches of representations and warranties as of June 1998. This analysis does not consider other factors that affect the actual amount realized, such as earned interest and spreads between the certificate balances and underlying collateral.

Table 5: Net Proceeds As of June 1998 From Lomas Transactions

Source/Application of Funds	Amount (in millions)
Sales proceeds net of expenses	\$2,142.2
Outstanding PRFs	(28.2)
Draws on CRFs	(19.2) ^a
Claims paid	(77.7)
Amount Realized	\$2,017.1

^aFDIC officials did not provide CRF data for transaction 1993-04P.

Source: OIG analysis of the RTC's *Closing Analysis by Institution* and the FDIC's PRF, CRF, and claims data.

While the amounts shown in table 5 reflect amounts as recorded, improper transactions affect the validity of those amounts. For example, FNMC made draws from the CRFs between May 1996 and February 1998 totaling \$5.4 million. Those draws were made for shortfalls due to missing payments for transactions 1992-11, 1992-15, and 1992-18P, which is in direct contradiction to the intended purpose of the CRFs. On November 6, 1997, the FDIC notified FNMC that draws from the CRFs for issues other than delinquencies and realized losses were not allowable. Similarly, reimbursements for previous draws from the PRFs were made to CRF accounts. For example, for transaction 1992-11, FNMC made draws and reimbursements through February 1998 that resulted in about \$3.8 million of PRFs being deposited into CRF accounts. In addition, FNMC and Bankers Trust balances for the CRFs differed. As of November 6, 1997, FNMC showed a balance of more than \$60 million while Bankers Trust showed a balance of \$33.4 million for the same period.

Based on our audit, FDIC officials—specifically, MBSA, DOF, Legal Division, and Asset Claims Administration—met with FNMC on June 2, 1998, to discuss the reconciliation process and the unresolved issues affecting reconciliation and settlement of the transactions. Subsequently, the FDIC and FNMC agreed to conduct the pilot reconciliation project on transaction 1992-15, discussed above, and to monitor the results of that project to determine the feasibility of expanding the results to the remaining Lomas transactions.

CONCLUSIONS AND RECOMMENDATIONS

The current status of the Lomas transactions can be traced to a number of problems in the RTC's structuring of the transactions and lack of oversight and failure to take timely action by the RTC, the FDIC, and Lomas. In addition, Lomas did not properly account for the PRFs. Although FDIC officials have begun to address some of the problems related to the Lomas transactions, any attempt to reconcile and settle those transactions will be hindered. First, the length of time that has passed since the transactions were originated will make it difficult to obtain accurate beginning balances for the securitized loans. Second, the adequacy and accuracy of records generated and maintained by Lomas are questionable. Finally, it will take substantial time and effort to complete the reconciliations, if indeed that can be done.

Before any attempt at full scale reconciliation occurs, the FDIC needs to resolve several issues related to the Lomas transactions. Specifically, the FDIC needs to (1) establish whether FNMC is liable for reconciliation and settlement and returning outstanding PRFs, (2) determine how the \$10.1 million received from NationsBanc is related, and (3) settle all outstanding claims. The FDIC also needs to determine the feasibility and cost-effectiveness of completely reconciling the transactions. Accordingly, we recommend that the Director, DRR, and the Acting Director, DOF:

- (1) Form a task force consisting of representatives from the DRR's MBSA and Asset Claims Administration, DOF, and Legal Division to jointly review and resolve all outstanding issues related to reconciling and settling the Lomas transactions, which include
 - obtaining a legal determination of FNMC's liability for returning outstanding PRFs to the FDIC,
 - determining the relationship of the \$10.1 million received from NationsBanc to the Lomas transactions,
 - reviewing and resolving all claims filed relating to the Lomas transactions, and
 - evaluating the feasibility and cost-effectiveness of reconciling the Lomas transactions.

CORPORATION COMMENTS AND OIG EVALUATION

The Associate Director, DOF, and Assistant Director, DRR, provided a joint written response to a draft of this report on December 15, 1998. The response agreed with the recommendation and provided the requisites for a management decision. The response is not summarized because the actions planned or completed are identical to those recommended. The Associate Director's and Assistant Director's response is presented as appendix II to this report. Appendix III presents management's proposed action on our recommendation and shows that there is a management decision for the recommendation in this report.

THE RTC'S ORIGINATION AND OVERSIGHT OF THE LOMAS TRANSACTIONS

The RTC's origination and oversight of the Lomas transactions created management and reconciliation problems that affected the FDIC's ability to reconcile the transactions and recover outstanding PRFs. The RTC's structuring of the loans and loan servicing for the transactions, as well as its failure to provide adequate criteria for the use and return of PRFs, created management and oversight problems. Furthermore, the RTC failed to take timely corrective actions when alerted to problems regarding the Lomas transactions. The RTC's structuring of the transactions has resulted in over \$117 million of filed claims related to breaches of representations and warranties provided by the RTC.

THE RTC DID NOT PROPERLY ORIGINATE THE LOMAS SECURITIZATION TRANSACTIONS

The RTC structured the five Lomas transactions differently from its other securitization transactions. The Lomas transactions consisted of loans serviced by others and required primary servicers to continue servicing the loans and remit monthly loan payments to Lomas (master servicer). The types of loans that the RTC included in the Lomas transactions also presented a multitude of managerial problems for the master servicer and the RTC. Specifically, the RTC made numerous errors in the types of loans it included in the five transactions, which breached the representations and warranties it provided to the master servicer.⁹ In addition to making numerous errors when it originated the Lomas transactions, the RTC did not always provide adequate criteria for the use and return of the PRFs established for those transactions. The errors made in originating the transactions and the inadequate criteria provided to the master servicer exacerbated the magnitude of problems associated with the transactions and significantly affected the reconciliation and settlement of the transactions.

Problems Related to the Structure of the Lomas Transactions

The five transactions for which Lomas was the master servicer were voluminous from the standpoint of the (1) number and type of loans included, (2) number of entities that provided servicing, and (3) number of financial institutions involved. In total, the five transactions consisted of 59,331 loans of varying types, 386 loan-servicing entities, and 986 financial institutions. The unpaid principal loan balances of the transactions totaled over \$2.4 billion.

⁹The RTC originated its securitized transactions with involvement from multiple contractors including financial advisors and due diligence contractors. Financial advisors provided advice after a contractor completed due diligence of the loans to be securitized. For the five Lomas transactions, there were two financial advisors and five due diligence contractors.

Table 6 shows the number of institutions, servicers, and loans as well as the total unpaid principal loan balances for each of the Lomas transactions.

Table 6: Numbers of Institutions, Servicers, Loans, and Total Loan Balances

Transaction Number	Number of Financial Institutions	Number of Primary Servicers	Number of Loans	Principal Loan Balances^a (millions)
1992-11	216	55	23,288	\$1,001
1992-15	220	72	14,098	621
1992-18P	221	130	10,724	408
1993-04P	193	69	1,495	69
1993-05P	136	60	9,726	300
Totals	986	386	59,331	\$2,401^b

^aPrincipal loan balances are as of the cut-off date of the transaction.

^bTotal does not add due to rounding.

Source: OIG analysis of information provided by Bear Stearns and Lomas from RTC, OIG audit report number A94-KC-010, dated June 6, 1994, and NSSO transaction data.

Further, the types of loans included in each transaction varied considerably. Specifically,

- transaction 1992-11 included performing single-family mortgage loans with various fixed and adjustable rates;
- transaction 1992-15 included whole and participation single-family mortgage loans with both fixed and adjustable rates;
- transaction 1992-18P included single- and multi-family mortgage loans and commercial loans based on fixed-rate collateral, treasury-based adjustable-rate collateral, and multiple indices;
- transaction 1993-04P primarily included single family performing, subperforming, and nonperforming mortgage loans and real estate acquired through the foreclosure of mortgage loans; and
- transaction 1993-05P consisted of performing and nonperforming, whole and participation, single-family mortgage loans with both fixed and adjustable rates.

All of the RTC's master servicers, except those servicing LSBO transactions, were responsible for servicing and collecting the monthly payments on the pooled loans and forwarding those collections to the trustee for distribution to the investors. However, with the LSBO transactions, the master servicer acted as a conduit, with primary servicers collecting the loan payments and forwarding them to the master servicer for transmittal to the trustee. The Lomas transactions had

multiple primary servicers consisting of both RTC controlled and non-RTC controlled third parties that owned the servicing rights.

Errors Made in Originating the Transactions

Apart from the sheer number of loans and primary servicers involved in the Lomas transactions, the RTC included loans that significantly affected Lomas' ability to service the loans in compliance with the pooling and servicing agreements. Specifically, the RTC included loans that the Corporation did not own or had been liquidated before the transactions closed as well as loans with incorrect participation percentages, incorrect beginning balances, and different payment schedules. Any shortfalls from the expected cash flow of those loans should have been initially funded from the PRFs. Accordingly, the RTC's errors resulted in increased draws on the PRFs and substantially increased the number of claims related to the Lomas transactions.

The pooling and servicing and master-servicing agreements, in addition to outlining the duties and responsibilities of the RTC, master servicer, and trustee, also provided the RTC's representations and warranties made to the master servicer. The RTC pledged no material issues existed that would negatively affect the master servicer's ability to service the loans. Specifically, the RTC guaranteed that

- information describing the pooled loans was correct in all material respects;
- the RTC had clear title to the loans;
- the underlying loan collateral was free of liens, except for current taxes, and in good condition;
- the real-estate collateral was supported by title insurance in full force and effect or attorneys' title opinions; and
- the loans were not delinquent beyond a specified date.

The RTC's haste to complete the securitization deals and the resulting errors in identifying and selecting loans to be included in the deals contributed to breaches of the representations and warranties made to the master servicer. In a memorandum dated February 25, 1998, FNMC outlined its observations and concerns regarding breaches of representations and warranties as well as other miscellaneous origination problems, such as reporting on beginning loan balance discrepancies and loan activity. Table 7 shows the types of origination errors as well as their effects on the PRFs and representations and warranties funds.

Table 7: Lomas Transactions Origination Problems and Related Effects

Transaction Origination Problem	PRF Draw to Cover Shortfall	Reimbursement to PRF Expected	Method of Reimbursement^a
Loans sold in error	Yes	Yes	Claim
Incorrect participation percentages	Yes	Yes	Claim
Incorrect beginning balances	Yes	Yes	Claim
Preacquisition liquidations	Yes	Yes	Claim
Different payment schedules	Yes	Yes	Claim

^aClaims should be made against the representations and warranties funds to reimbursement the PRFs.

Source: OIG review of FNMC analysis of origination errors and PRF draws and FNMC and MGIC claims data.

Loans sold in error consisted of loans that the RTC did not own or had included in other RTC securitized transactions. Those errors caused the initial values of the loan pools to be overstated, which also overstated the monthly scheduled distributions to investors. Since actual receipts from borrowers were less than anticipated, draws were made from the PRFs to make the scheduled monthly payments to investors. To cure those errors, the master servicer filed claims with MISC to cover the cost of buying out the unpaid principal balances of the loans that were improperly included in the transactions. The funds received from the claims should have been used to reimburse the PRFs.

Incorrect participation percentages included loans on which the RTC overstated its ownership percentage. For example, the RTC included loans in the transactions as wholly owned when the Corporation may have owned only 10 percent of the loans, thereby erroneously increasing the monthly loan payments expected to be credited to the RTC. This type of error also overstated the amounts that the master servicer expected to receive, monthly scheduled distributions to investors, and withdrawals from the PRFs. To correct those errors, the master servicer filed claims to cover the cost of buying down the unpaid principal balances to the correct participation percentages. The funds received from the claims should have been used to reimburse the PRFs.¹⁰

Incorrect beginning balances included loans on which the RTC overstated the unpaid principal balances and preacquisition liquidations included loans that had been paid in full before the transactions closed. Both of those types of errors affected expected monthly cash flows by overstating the scheduled monthly payments that the master servicer expected to receive, which increased draws from the PRFs. To correct those errors, the master servicer filed claims to cover the missing payments or the cost of buying down the unpaid principal balances to the correct beginning balances. The funds received from the claims should have been used to reimburse the PRFs.

Loans with different payment schedules were loans with bimonthly, biannual, annual, and balloon payment schedules, which the RTC included in the transactions as loans with monthly payments.

¹⁰The RTC also included some loans on which it understated its participation or ownership percentages. For example, the RTC may have owned 90 percent of a loan and included it in the transaction at a 10-percent ownership. Those errors resulted in the master servicer receiving larger payments than expected for those loans.

Because the securitizations guaranteed investors steady, predictable streams of payments, the master servicer withdrew money from the PRFs to cover monthly shortfalls created by the different loan payment schedules. Although the master servicer was required to file a claim with the RTC or MISC for loans that breached representations and warranties, Lomas initially drew funds from the PRFs to cover shortfalls in expected monthly distributions to investors. If claims were filed, funds received should have been used to reimburse the PRF draws.

The RTC did not provide additional clarification to assist master servicers in resolving transaction problems or specific procedures for filing claims related to breaches of representations and warranties until November 2, 1993, and November 1, 1994, respectively. The RTC held the first of those meetings almost 1 year after it originated the last Lomas transaction.

Lack of Adequate Criteria Governing Payment Retention Funds

Although the RTC established four PRF accounts containing \$60.3 million for the Lomas transactions, the RTC did not provide adequate criteria to govern the use, investment, and return for two of the four accounts. The RTC's servicing agreements with Lomas for two of the four transactions contained no reference to the PRFs. Specifically, the agreements for transactions 1992-15 and 1993-05P did not refer to the amount, specific purpose, or expected return date for PRFs totaling \$19,739,897. The RTC established criteria for transaction 1992-11 through an ancillary agreement signed by both the RTC and Lomas and for transaction 1992-18P by including criteria for the PRF in the pooling and servicing agreement.

According to the FDIC's counsel who was knowledgeable about the RTC's pooling and servicing agreements with Lomas, the RTC purportedly negotiated ancillary agreements on all four transactions for which a PRF was established. However, neither the FDIC counsel nor MBSA officials could find those agreements. Accordingly, we could not verify that Lomas and FNMC officials were provided PRF criteria for transactions 1992-15 and 1993-05P. The ancillary agreement for transaction 1992-11 stated that the PRF was established for a 3-month period and was to be returned to the Corporation in full, along with any earned interest, after the 3-month period expired.

Although the RTC generally established PRF accounts in the names of the master servicer and the Corporation, it established the Lomas PRF accounts in the names of the trustee and the Corporation with Bankers Trust controlling the accounts.

THE RTC DID NOT TAKE TIMELY ACTION ON PROBLEMS RELATING TO LOMAS' TRANSACTIONS

During 1993 and 1994, the RTC was alerted to significant accounting and reporting issues and oversight concerns related to the Lomas transactions. For example, according to an NSSO memorandum dated October 25, 1996, between September 1993 and December 1993, the RTC received approximately \$30 million in unidentified funds from master servicers. Ultimately, the

RTC received over \$60 million in such funds for which there was no loan-level or institution-level data.

TCBA, NSSO's accounting contractor, developed and executed a plan to identify the loans and financial institutions that the funds related to and then distribute the funds to the appropriate RTC field offices. TCBA identified loan payments that (1) belonged to the trust, (2) could not be tied to specific owners, and (3) were in process for distribution to RTC's field offices. TCBA relinquished this reconciliation project to the FDIC on December 31, 1996, at the end of its contract.

Further, in June 1994, the RTC's OIG issued a report resulting from an audit of Lomas' servicing of unsecuritized RTC loans. Lomas was servicing other RTC loans along with the loans that the RTC securitized in the five Lomas transactions. The audit report entitled *RTC's Oversight of Lomas Mortgage USA, Inc.* (A94-KC-010, dated June 6, 1994) identified the following problems:

- The RTC needed to improve its oversight of Lomas.
- Lomas' cash management practices needed improvement.
- The RTC did not provide Lomas with adequate accounting requirements or ensure that Lomas accurately identified securitized and unsecuritized loans, provided accurate loan activity reports, and complied with the terms of its servicing agreement.
- Lomas erroneously commingled funds from securitized and unsecuritized loans (e.g., Lomas deposited \$504,601 of securitized loan funds to the unsecuritized loan collection accounts).
- Lomas had \$1.9 million in deposits to unsecuritized loan collection accounts that were not supported by servicer remittance reports.
- Lomas had \$5.2 million in loan payments in a clearing account because it had not determined whether the funds related to securitized or unsecuritized loans.

Although the report did not specifically address the PRFs that RTC had established for Lomas' securitized transactions, it provided an early warning regarding Lomas' servicing of securitized and unsecuritized loans. However, when the FDIC assumed control of the Lomas transactions in January 1996, Lomas had not reconciled or returned the PRFs.

CLAIMS FOR BREACHES OF REPRESENTATIONS AND WARRANTIES WILL AFFECT FINAL SETTLEMENT

To reach final settlement, all claims related to the Lomas transactions need to be resolved. As of June 1998, over 4,600 claims totaling about \$117.1 million had been filed as a result of breaches in the RTC's representations and warranties provided under the Lomas transactions. The RTC and FDIC had paid about \$77.7 million of those claims and, as of June 1998, the FDIC had not

reviewed and resolved about \$6.4 million.

Lomas, FNMC, and other servicers filed representations and warranties claims for various reasons, including buyouts and buydowns of erroneous unpaid principal balances included in the transactions. Specifically, claims to buy out loans were associated with loans that the RTC should not have included in the transactions. Claims to buy down loan loans were associated with incorrect beginning loan balances or participation percentages. Both buyouts and buydowns ensured that correct scheduled payments were passed on to investors.

According to an FNMC official, in 1994, approximately 1 year after the transactions were originated, the RTC provided guidelines for filing claims with MISC to remedy breaches of representations and warranties. Specifically, the RTC instructed servicers to submit claims to MISC to buy out or buy down principal balances to cure inappropriately included loans or incorrectly stated beginning balances and participation percentages. Table 8 shows the claims that were filed by type of claim.

Table 8: Claims Filed and Paid Related to the Lomas Transactions

Type of Claim	Claims Filed	Claims Paid
Cure ^a	\$ 43,074,320	\$27,610,574
Previously sold asset	36,880,491	27,453,295
No value asset	24,302,682	21,222,181
Repurchase	6,462,642	1,263,925
Other claims ^b	6,399,942	171,678
Total	\$117,120,077	\$77,721,653

^aCure includes buying out or buying down inappropriately included loans and incorrect beginning loan balances or participation percentages.

^bOther claims includes those resulting from full scale or standard audits, credit losses, and loading expenses.

Source: OIG analysis of the FDIC, Asset Claims Administration; MGIC; and FNMC databases.

Because claims play a major role in the reconciliation process, it is important for the FDIC and FNMC to be knowledgeable regarding all claims issues. However, before the OIG informed FDIC officials in December 1997, they were not aware that FNMC had additional claims to be filed. Likewise, FNMC was not aware that several primary servicers (i.e., NationsBanc and Boatmen's National) had also filed and received reimbursement for claims. The FDIC's and FNMC's data regarding the number and amount of claims filed varied considerably. For example, FNMC's data showed that Lomas and FNMC had filed about \$85 million in claims while the FDIC's and MGIC's data showed \$94.2 million in Lomas and FNMC claims. In addition, FNMC officials stated that the FDIC had instructed them to discontinue filing claims until final settlement. However, all claims should be considered in reaching final settlement.

Accordingly, to ensure appropriate reconciliation and settlement of the Lomas transactions, the FDIC and FNMC needed to resolve obvious differences regarding the number of claims filed and

paid and the appropriateness of those claims. During a June 2, 1998, visit to FNMC, FDIC officials requested that FNMC submit all outstanding claims to the FDIC's Asset Claims Administration for review and processing. The officials agreed to assist FNMC in ensuring that all claims met documentation requirements.

CORPORATION COMMENTS

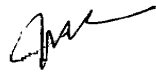
FDIC**Federal Deposit Insurance Corporation**550 17th Street, NW, Washington, DC 20429


December 15, 1998

MEMORANDUM TO:

Sharon M. Smith
Director, Field Audit Operations
Office of Audits
Office of Inspector General

FROM:


J. Russell Cherry
Associate Director
Division of Finance


Sandra Thompson
Assistant Director
Division of Resolutions and Receiverships

SUBJECT:

Draft Audit of Payment Retention Funds Established by the
Resolution Trust Corporation for Securitized Transactions
Serviced by LOMAS Mortgage USA

Thank you for the opportunity to comment on this draft report (audit number 97-101). In the interest of time, DRR and DOF, with the support of the Legal Division, are responding jointly to your draft report. The following describes the management actions completed in response to recommendations contained in the above referenced report.

- 1) Form a task force consisting of representatives from the DRR's MBSA and Asset Claims Administration, DOF, and Legal Division to jointly review and resolve all outstanding issues related to reconciling and settling the Lomas transactions.

Response: We (DRR MBSA, DRR Asset Claims Administration (ACA), DOF, and Legal) agree with the recommendation cited in the audit report.

A. Specific Corrective Action Already Taken:

DRR MBSA, ACA, DOF, and Legal have already established a working group and are actively working to review and resolve the outstanding issues related to settling the Lomas transactions.

B. Corrective Action to be Taken Together with Expected Completion Date:

None needed. Action already taken as noted in 1) A.

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C. Documentation that will confirm the completion of the corrective action:

None needed. Corrective action already taken as noted in 1) A.

2) Obtain a legal determination of FNMC's liability for returning outstanding PRA's to the FDIC.

Response: We concur with the GIG recommendation.

A. Specific Corrective Action Already Taken:

We have received a legal opinion dated November 17, 1998 that FNMC assumed all LOMAS liabilities when they acquired the LOMAS servicing operations.

B. Corrective Action to be Taken Together with Expected Completion Date:

None needed. Action already taken as noted in 2) A.

C. Documentation that will confirm the completion of the corrective action:

Hard copy attached to this response.

3) Determine the relationship of the \$10.1 million received from NationsBank to the Lomas transactions.

Response: We concur with the GIG recommendation.

A. Specific Corrective Action Already Taken:

We have reviewed all documents that the FDIC has received to date related to the \$10.1 million received from NationsBank, one of the primary servicers for the transactions.

B. Corrective Action to be Taken Together with Expected Completion Date:

The EDIC continues to direct FNMC, as master servicer, to obtain better and more detailed information from NationsBank on these funds. Whether any additional information exists is questionable. The FDIC has made multiple requests of NationsBank concerning documentation to support the \$10.1 million that they returned the FDIC. Their staff has and continues to state that Boatmen's staff informed them at the time of their merger that the funds belonged to the

FDIC and should be returned. At this time, we only have documents from NationsBank stating how much of the funds should be allocated to each Series. NationsBank continues to state that all the funds are related to the Series in question. If no better information is obtainable, a determination will be made as to how to best credit the funds towards the PRA reconciliation. It is anticipated that this determination will be made no later than March 16, 1999.

C. Documentation that will confirm the completion of the corrective action:

MBSA and DOF will maintain copies of documentation in their files.

4) Review and resolve all claims filed relating to the Lomas transactions.

Response: We concur with the OIG recommendation.

A. Specific Corrective Action Already Taken:

The working group has actively worked with FNMC in an effort to resolve all outstanding claims. To date FNMC has submitted 328 claims totaling \$11 million to ACA for their review, of which 190 totaling \$4.8 million have been approved, 29 totaling \$211,000 have been denied and 109 totaling \$4.8 million are under review. FMNC has indicated that they have submitted all outstanding claims to ACA.

B. Corrective Action to be Taken Together with Expected Completion Date:

ACA will complete the process of reviewing and resolving all claims related to the Lomas transactions. The review is scheduled for completion by 04/30/99.

C. Documentation that will confirm the completion of the corrective action:

ACA will maintain all records related to the claims review process.

5) Evaluate the feasibility and cost-effectiveness of reconciling the Lomas transactions.

Response: We concur with the OIG recommendation.

A. Specific Corrective Action Already Taken:

We concur that management should evaluate the feasibility and cost-effectiveness of reconciling the Lomas transactions. Through our continued discussions with

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FNMC, they have now provided the FDIC with the best information available related to 92-15. MBSA has facilitated the return by FNMC of an additional \$7.6 million to the FDIC which has been credited towards the reconciliation. FNMC has also agreed to compensate the FDIC for lost interest on this amount. We are actively reviewing additional information FNMC has provided and simultaneously continuing our discussions. We have directed FNMC to commence a limited reconciliation of 92-11 and 92-I 8P based on cash flows through the collection account. As the OIG report indicates it may not be feasible to reconcile the transactions at the loan or institutional level. However, as we gather and review financial information provided by FNMC, we should be able to better determine the aggregate amount that may be due the FDIC by FNMC.

B. Corrective Action to be Taken Together with Expected Completion Date:

As we gain additional information, we will be able to determine when information retrieval efforts are no longer beneficial. At that point, we anticipate final settlement will be achieved through negotiation or legal action. We estimate that final settlement will take place by August 31, 1999.

C. Documentation that will confirm the completion of the corrective action:

MBSA and DOF will maintain copies of all correspondence and documentation in their files.

CC: John Bovenzi
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MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report on the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider the FDIC's responses as management decisions in accordance with the act and related guidance, several conditions are necessary. First, the response must describe for each recommendation

- the specific corrective actions already taken, if applicable;
- corrective actions to be taken together with the expected completion dates for their implementation; and
- documentation that will confirm completion of corrective actions.

If any recommendation identifies specific monetary benefits, FDIC management must state the amount agreed or disagreed with and the reasons for any disagreement. In the case of questioned costs, the amount that the FDIC plans to disallow must be included in management's response.

If management does not agree that a recommendation should be implemented, it must describe why the recommendation is not considered valid.

Second, the OIG must determine that management's descriptions of (1) the course of action already taken or proposed and (2) the documentation confirming completion of corrective actions are responsive to its recommendations.

This table presents the management responses that have been made on recommendations in our report and the status of management decisions. The information for management decisions is based on management's written response to our report.

Rec. Number	Corrective Action: Taken or Planned / Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	The Associate Director, DOF, and Assistant Director, DRR, agreed with the recommendation and stated that the Corporation has formed a working group to review and resolve the outstanding issues related to settling the Lomas transactions.	08/31/99	Settlement agreement.	\$-0-	Yes